Internal Revenue Service

memorandum

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Brl:HFRogers

date: SEP 20 1988

to: District Counsel, Milwaukee CC:MIL

from: Director, Tax Litigation Division CC:TL

subject: Allocation of withholding credits and estimated tax payments in community property states

This is in response to your request for technical advice dated June 15, 1988.

ISSUE

Whether the holding in Janus v. United States, 557 F.2d 1268 (9th Cir. 1977), should continue to be followed. In other words, when a taxpayer files a separate declaration of estimated tax and a separate income tax return, whether that taxpayer is entitled to credit for the entire amount of estimated taxes he or she paid.

CONCLUSION

The decision in Janus should continue to be followed for separate estimated tax payments. However, the other spouse's return should also be examined and if that spouse has an interest in the estimated payment under local law, and there is a deficiency, the Service can exercise its federal lien rights in the estimated payment pursuant to I.R.C. § 6321. Further, since Wisconsin law apparently makes the whole of the community property subject to either spouse's obligations, any estimated tax overpayment by one spouse may be set off against the tax obligations of the other spouse. There is presently a difference of opinion among the divisions in the National Office regarding the proper treatment of withholding credits. After further coordination and reconciliation on this issue, we will send you a supplemental technical advice.

FACTS

Wisconsin enacted the Wisconsin Marital Property Act, which was effective January 1, 1986. This act created a community property system for Wisconsin residents.

DISCUSSION

Generally, under community property law, wages earned by either spouse are community income. As such, one-half is attributable to each spouse. The interest of each spouse in the earnings of the other continues until the marriage is terminated by death or divorce. If each spouse files a separate income tax return, each has the obligation to report one-half the community income on his or her return. United States v. Mitchell, 403 U.S. 190, 196 (1971); Hall v. Commissioner, T.C. Memo. 1980-419, aff'd, unpublished opinion (5th Cir. Sept. 15, 1981), cert. denied, 456 U.S. 944 (1982).

Although, generally, community property law requires each spouse to report one-half the community income on his or her separate income tax return, the Ninth Circuit in Janus, supra, and the Tax Court in Morris v. Commissioner, T.C. Memo. 1966-245, have held that estimated tax payments need not be split between the spouses. The court in Janus held "payments made by a taxpayer in accord with a separate declaration of estimated tax must be credited solely to the taxpayer if he files a separate tax return." 557 F.2d at 1270. In Morris, the court concluded, "Under section 6015(b), in order to divide estimated tax payments between a husband and wife, a joint declaration of estimated tax is required." 25 T.C.M. at 1255. The Service has adopted this position. See GCM 38049, Overpayments Arising from Joint Returns, I-224-76 (Aug. 15, 1979); OM 70487, [redacted], TL-R-834-73 (Oct. 18, 1979).

To reach their conclusion both courts examined the provisions of section 6015. However, as part of its 1984 tax simplification plan, Congress repealed section 6015, effective after December 31, 1984. There is no similar provision in section 6654 which now contains the rules for paying estimated taxes for individuals.

Therefore, although each spouse in Wisconsin has a one-half interest in the income earned by the other spouse, it does not necessarily follow that each spouse has a one-half interest in estimated tax payments. Notwithstanding, the Service has

the right to exercise its federal lien rights in order to credit the liable spouse's entire interest in the overpayment against the liable spouse's outstanding separate tax liability. This can be done pursuant to section 6321, 6322, 6331, 6335 and, in some cases, by set off.

Section 6321 provides that if any person liable to pay any tax neglects or refuses to pay the same after demand, the amount of the tax plus interest and additions shall be a lien in favor of the United States upon all property and rights to property belonging to such person. Section 6322 provides that, unless otherwise provided, a lien imposed by section 6321 shall arise at the time the assessment is made and shall continue until the liability for the amount so assessed is satisfied or becomes unenforceable by reason of lapse of time. Section 6331 authorizes the Secretary, 10 days after notice and demand, to satisfy an outstanding tax liability by levy upon all property and rights to property subject to the lien provided in section 6321. Section 6335 requires the Secretary as soon as practical after the seizure of property to notify the owner of the property that the property has been seized.

Whether a taxpayer has an interest in property or rights to property is determined by whether state law classifies his interest as property or rights to property. Aquilino v. United States, 363 U.S. 509 (1960). Once it is determined that a taxpayer has property or rights to property, federal law then controls in determining whether or not a lien will attach. United States v. Bess, 357 U.S. 51 (1958). Mere state exemption statutes are ineffective against a statutory lien of the federal government for federal taxes. United States v. Hoper, 242 F.2d 468 (7th Cir. 1957).

The portion of the community property subject to a federal tax lien depends on the liable spouse's interest in the property under state law. Even where the property is not subject to levy by the creditors of the liable spouse under state law, courts have held such state law to be an exemption statute which would be ineffective in preventing a federal tax lien from attaching. In those states where creditors can only reach their debtor's one-half interest in community property, the federal tax lien would only attach to the liable spouse's undivided one-half interest in the community property. Broday v. United States, 455 F.2d 1097 (5th Cir. 1972); United States v. Overman, 424 F.2d 1142 (9th Cir. 1970); In the Matter of Ackerman, 424 F.2d 1148 (9th Cir. 1970). Where, pursuant to state law, the entire community interest could be reached

by the creditors of the liable spouse, the entire community interest in the property is subject to attachment by the federal tax lien. See Babb v. Schmidt, 496 F.2d 957 (9th Cir. 1974).

State law also determines the manner in which the Service should exercise its federal tax lien rights in the estimated tax payment. In all states, the Service can exercise its federal lien rights by levying on the estimated tax payment in its possession in accord with sections 6331 and 6335. In addition, the Service can assert its creditor's rights by common law set off in the appropriate community property states. These states are those where community property is entirely subject to the separate debt of either spouse. It is recommended that the Service use its right of set off in those states where it is available.

The common law right of set off is different from and in addition to the Service's statutory right of set off under section 6402. In United States v. Munsey Trust Co., 332 U.S. 234, 239 (1947), the Supreme Court stated: "The government has the same right 'which belongs to every creditor, to apply the unappropriated moneys of his debtor, in his hands, in extinguishment of the debts due to him.'" (Citation omitted.) See Eaves v. United States, 433 F.2d 1296 (10th Cir. 1970); Santos v. United States, 277 F.2d 806 (Ct. Cl.), cert. denied, 364 U.S. 913 (1960).

It appears that Wisconsin is one of the states in which all community property would be subject to a tax lien. See Wis. Stat. §§ 766.55(2)(b), 71.13(1)(d) (1987). Therefore, the Service can use its common law right of set off to apply the nonliable spouse's estimated tax payments to the liable spouse's tax deficiency where the source of the overpayment is community property.

In light of the above, no inequity results from following the procedures established after the holding in Janus. The Service will keep all funds it is entitled to, and both taxpayers' tax liabilities will be paid. One of the reasons the court gave for its decision in Janus was that if there was any overpayment, it would not be credited to the wife's account. Using the example in the request for technical advice, each spouse would report $25,000 in income and the husband would have an estimated tax credit of $15,000. He would be entitled to a refund for any overpayment resulting from the use of community funds except to the extent the Service set off or levied against the overpayment to satisfy his wife's tax liability.

In examining [redacted], OM 18259, I-364-75 (Sept. 4, 1975), the Interpretative Division recognized that withholding

credits should be treated differently than estimated tax payments. Estimated taxes should be allocated pursuant to Treas. Reg. § 1.6015(b)-1(b), or if the spouse files a separate estimated tax payment and a separate income tax return, the allocation should be in accord with the discussion in this technical advice. However, Treas. Reg. § 1.31-1(a) provides for a one-half credit to each spouse in a community property state for taxes withheld from one spouse's wages where each spouse reports one-half the wages in a separate return.

The Tax Court has recently voiced concern about the Service's splitting of withholding credits. Furthermore, as mentioned previously, section 6015 has been repealed. In light of these considerations, this issue is the subject of renewed concern and examination in the National Office. When a conclusion has been reached, a supplemental memorandum will be forwarded.

In the meantime, estimated tax payments should continue to be allocated in accord with this technical advice. Withholding credits may be split one-half to each spouse.

If you have any further questions, please contact Helen F. Rogers at FTS 566-3442.

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